



MARKET & ECONOMIC REVIEW

Overview

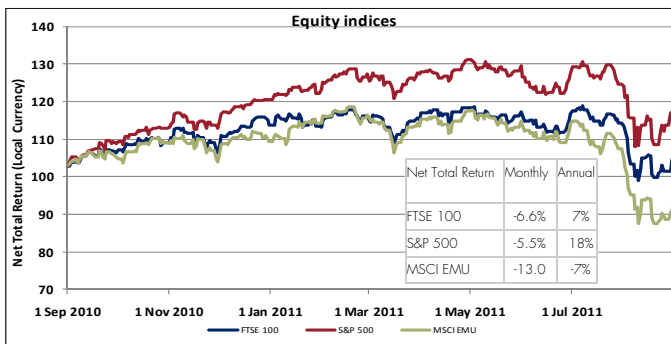
Equity markets fell significantly in early August, with the FTSE briefly dipping below the psychological barrier of 5000. Jittery investors, worried about global growth and eurozone stability, sought out safe havens and the price of gold reached record highs. The yields on UK and US government bonds fell, with the yield on 10 year gilts reaching its lowest level since the 1890s. The end of the month saw riskier assets recover slightly but markets remained volatile.

In the Bank of England's Inflation Report, forecasts of UK growth were revised down and the minutes of the MPC meeting reflected expectations of a more prolonged slowdown. For the first time since May 2010, no MPC members voted for an increase in interest rates.

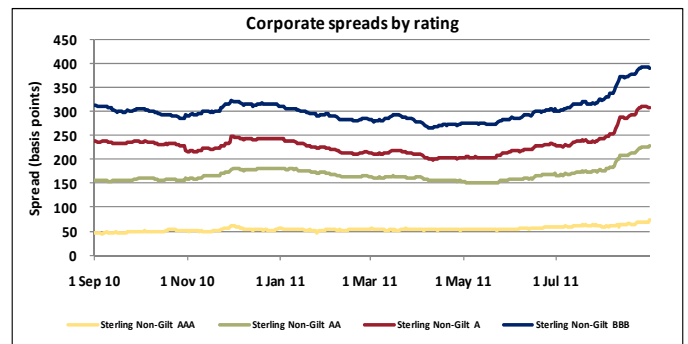
The ECB restarted bond purchases and intervened to buy Spanish and Italian bonds. The policy appeared to be successful in reducing the cost of Spanish and Italian borrowing; however, it has been politically controversial with the German president questioning its legality.

At the start of the month, S&P lowered their US government credit rating from AAA to AA+. However, Fitch and Moody's reaffirmed their AAA ratings and the announcement appeared to have little impact on the demand for US bonds.

Equity markets fell significantly this month



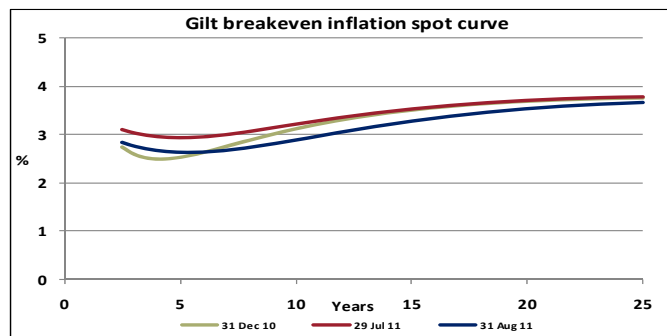
Credit spreads increased this month



LATEST ECONOMIC NUMBERS

Current Base Rate	0.5%
CPI increase July (%y/y)	4.4%
Halifax house prices July (%m/m)	0.3%
IPD TR property index July (%m/m)	0.6%
UK total trade balance June	−£4.5bn
VIX (volatility) index	31.6
\$/£ exchange rate	1.63
Numbers as at the end of month unless stated	

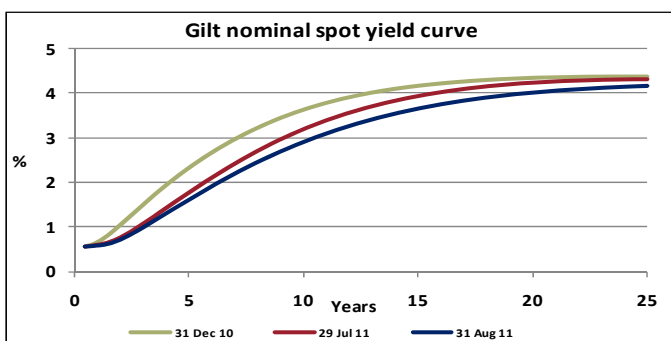
Breakeven inflation fell across the curve



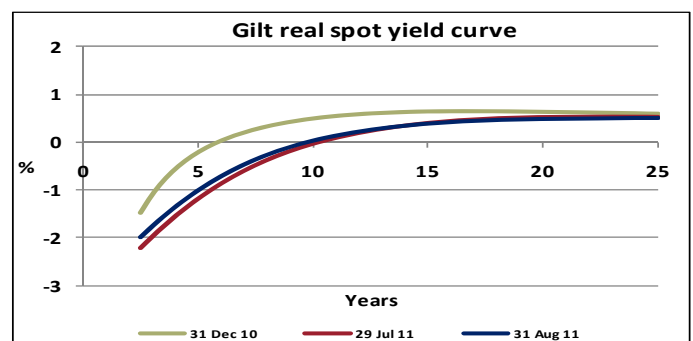
CALENDAR OF EVENTS AND DATA RELEASES

MPC interest rate announcement	8th Sept
Producer Price Index	9th Sept
UK Trade	9th Sept
RPI / CPI	13th Sept
Minutes of MPC meeting	21th Sept
BoE credit conditions survey	28th Sept
M4 Growth	29th Sept

Nominal yields decreased this month



Real yields remain largely unchanged





Responsible Investment

Asset owners are increasingly looking at integrating environmental, social and governance (ESG) issues into investment decisions, often under the title of 'responsible' or 'sustainable' investment. Over the years, socially responsible investment has evolved from the use of negative screening and the exclusion of sectors on 'ethical' criteria, to positive screening or a 'best in class approach', where top performers are selected. Today, responsible investing is increasingly focussed on not only the integration of ESG factors into investment analysis but also on a proactive approach to shareholder engagement. Those who practice this form of responsible investing believe that it will help maximise long-term financial performance, while also meeting social and environmental goals.

Legal Context

Where asset owners, such as pension funds, have a fiduciary duty to beneficiaries, many perceive this as a barrier to considering ESG issues. This is because they believe that financial returns should be their only concern. However, there has been an increasing realisation that ESG issues can also be considered, if this is done by following an appropriate process. In 2005, Freshfields set out their legal opinion¹ that although the primary objective for pension funds should be to generate returns, it is not a breach of fiduciary duties, per se, to consider ESG factors. As an example, Freshfields stated that it is reasonable for pension funds to screen out investments which are expected to yield a poor return by virtue of their ESG credentials but that it is not reasonable to screen out investments so that the diversification of the portfolio is excessively reduced. Freshfields also believed that "a court would likely regard shareholder engagement as prudent provided that it is properly motivated, transparent, informed and objective". Many pension funds now operate responsible investment policies which reflect their beliefs that ESG factors will affect financial performance.

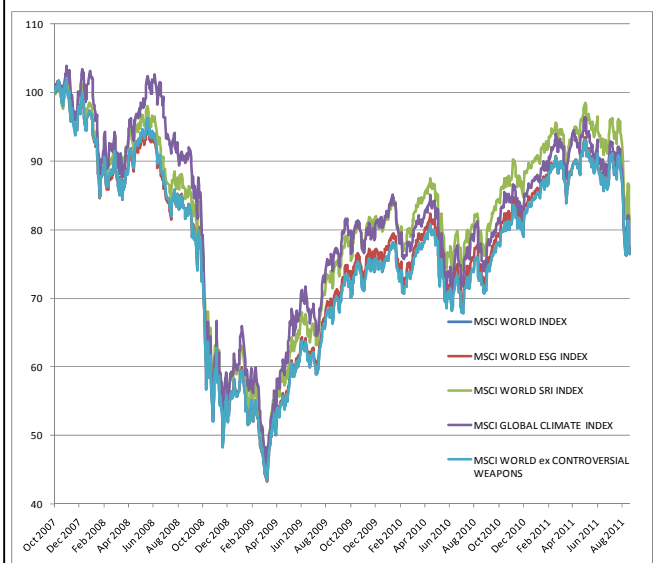
Financial performance

A key question for those who are considering responsible investing is whether there is a financial penalty for doing so. Proponents of responsible investing argue that consideration of ESG issues can help reduce exposure to risks, such as climate change, which can have a financial as well as a social impact. BP and the oil spill in the Gulf of Mexico is often used as an example of an investment which may have been avoided if ESG factors, and in particular health and safety practices, had been given greater consideration. However, this was also a share held by many responsible investment funds because of BP's leading approach to alternative energy amongst its peers. Academic evidence on the impact of responsible investment on financial performance is mixed, with papers showing a positive, negative or neutral impact depending on what was looked at and the methodology used. Responsible investment funds can often have a mid or small cap bias, although this can vary significantly.

Practicalities

There are many different approaches taken to responsible investing - in part reflecting a range of views on what people consider ethical. There are now a myriad of indices which use E, S and/or G criteria to exclude certain sectors, invest only in the highest rated companies or 'tilt' index weightings to reflect ratings. In addition there are active managers who use ESG factors in their investment process (and who may also have certain sector restrictions). For those who want to undertake responsible investment, consideration needs to be given to the most appropriate way of doing so. The UK Stewardship Code and the UN Principles for Responsible Investment provide a useful framework to inform responsible investment approaches.

Responsible investing index performance



There are now numerous indices to reflect responsible investing beliefs and objectives. Some, such as the MSCI global climate index, can be focussed on a relatively narrow single theme, whilst others, such as the MSCI world ESG index, can contain shares from any industry sector.

Source: MSCI

1. A legal framework for the integration of environmental, social and governance issues into institutional investment, October 2005

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Contact Information

Colin Wilson
Technical Director
T: +44 (0)20 7211 2672
E: colin.wilson@gad.gov.uk

Andrew Jinks
Investment & Risk Actuary
T: +44 (0)20 7211 2655
E: andrew.jinks@gad.gov.uk

Chris Bull
Trainee Actuary
T: +44 (0)20 7211 2739
E: christopher.bull@gad.gov.uk